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SUBJECT: Argentina Rides Bond-Price Rollercoaster Amid Market Concerns on Policy Direction

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Summary  
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**¶11.** (SBU) A series of interrelated events the week of August 4-8, including the GoA's private sale of US\$1 billion in sovereign bonds to Venezuela at a high yield, prompted a significant drop in GoA bond prices and a climb in Argentina's country risk premium to 741 basis points. On August 10, the GoA responded by announcing a US\$1 billion public debt buy-back program. An estimated US\$500 million in government purchases in the ensuing days helped bond prices recover much of the prior week's losses, notwithstanding significant market volatility generated by the August 11 GoA announcement of less-than-credible July inflation statistics, a downgrade by Standard & Poor's of Argentina's long-term debt rating from B-plus to B, and persistent rumors of possible cabinet changes, including the replacement of Economy Minister Carlos Fernandez and the removal of Internal Commerce Secretary Guillermo Moreno from his informal oversight of INDEC. Local market players call the GoA's successful bond buyback program a reactive and ad hoc response to pervasive concerns about the GoA's inability to formulate longer term policy responses to growing macro-economic disequilibria. By and large, these local market participants and analysts discount any medium-term default scenario and note that the GoA has the capacity to fund itself in local capital markets through 2009 absent any radical drops in global commodity prices. Near-term market sentiment will likely turn on steps the GoA takes - or fails to take - in the coming weeks to demonstrate its long-term economic vision and commitment to fiscal probity. End Summary.

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GoA Yields Approach Pre-2001 Crisis Levels...  
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**¶12.** (SBU) During the week of August 4-8, heightened financial market perceptions of Argentine risk drove up Emerging Market Bond Index country risk premiums on GoA sovereign obligations to a high of 741 basis points, a level not seen since just prior to Argentina's December 2001 \$93 billion default. The combined impact of a series of discreet events precipitated this darkening of market sentiment, beginning with President Cristina Fernandez de Kirchner's August 2 press conference -- the first in her eight-month tenure -- during which she defended her tough stance during the ag sector strike, offered unconditional support for Argentina's embattled national statistics agency INDEC, and backed her controversial Internal Commerce Secretary, Guillermo Moreno, widely accused of engineering the gross under-reporting of domestic inflation. Other developments negatively impacting perceptions of Argentine risk included:

-- a continued decline in global agricultural commodity prices (soy prices are down roughly 40% since July), on which Argentina's twin fiscal and trade surpluses have become dependent;

-- the private sale that week of US\$1 billion in sovereign GoA bonds to Venezuela at a yield of 14.87%, a rate not seen since before the

2001/2 economic crisis;

-- Venezuelan banks' rapid re-sale of these GoA securities into the secondary market which put pressure on bond prices; and

-- media reports that rating agencies Standard & Poor's and Moody's were contemplating downgrades of Argentine debt ratings.

**¶4.** (SBU) This confluence of developments added fuel to longstanding market concerns on the sustainability of a GoA fiscal policy mix that includes:

-- heavy government spending on energy and transportation subsidies (roughly 3% of GDP);

-- inadequate investment in primary infrastructure, particularly in energy infrastructure;

-- growing evidence that the GoA's still respectable primary surplus (+/- 3% of GDP) is being propped up by a combination of central bank profit contributions and non-transparent delayed payments on GoA-contracted infrastructure projects;

-- the GoA's intervention in INDEC;

-- continued concerns over as-yet-unresolved GoA frictions with the rural agricultural sector that could lead to further strikes and market disruptions;

-- the deteriorating finances of key provinces, including Buenos Aires and Cordoba (which together contribute 42% of national GDP), that is related to the growing concentration of tax revenues at the federal level and perceptions that the Kirchner administration is

distributing and withholding promised funds to reward political loyalty and punish dissident governors; and

-- the lack of any steps towards resolving longstanding claims by Paris Club sovereign creditors, bond "holdouts," and ICSID international arbitration claims.

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...And GoA Responds with Buy Back Program  
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**¶5.** (SBU) In response to a dramatic decline in GoA bond prices during the week of August 4-8 (an average drop of 6% in the price of Argentine sovereign dollar and peso bonds), Interior Minister Florencio Randazzo attributed the sell-off to manipulation by market speculators and said it did not reflect the economy's strength. On August 10, following a rare Sunday economic policy meeting at the Presidential residence that included CFK, Economy Minister Carlos Fernandez, Finance Secretary Hernan Lorenzino, Central Bank President Martin Redrado and Chief of Cabinet Sergio Massa, the GoA announced it would launch a public debt buy-back program. While the GoA did not initially announce the size of the program, it said that, in its initial phase, the program would focus on both dollar and peso bonds maturing in the remainder of 2008 and 2009. The GoA subsequently clarified that it had authorized up to \$1 billion for the buyback program - roughly equivalent to the amount it had received from the recent private debt sale to Venezuela.

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S&P Downgrade, Lowball Inflation Darken Sentiment  
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**¶6.** (SBU) On Monday, August 11, GoA bond prices recovered much of their prior week losses in early trading in response to what market players estimate was \$200 million worth of bond purchases by the GoA. However, late that afternoon, INDEC announced July inflation increases of only 0.4% m-o-m, the lowest increase in a year and a number that market participants found less than credible. In y-o-y terms, official headline inflation declined to 9.1%, from 9.3% in June. (The consensus forecast had been that INDEC would report an inflation rate of around 0.6% m-o-m, flat versus June. Private sector's estimates put July inflation at 1.0 - 1.5% m-o-m and around 25% in y-o-y terms).

¶ 7. (SBU) That same afternoon, Standard and Poor's downgraded Argentina's long-term debt rating by one notch from B-plus to B (five notches below investment grade), basing its decision on a view that GoA fiscal performance will continue to deteriorate due to slowing real GDP growth and government spending rigidities. The confluence of both non-credible INDEC data and the S&P downgrade promoted a sell-off of Argentine debt that halved price gains recorded earlier in the day.

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Bond Prices Recover, but INDEC Concerns Grow  
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¶ 8. (SBU) From August 12 - August 14, GoA bond prices continued to firm on the strength of GoA purchases, with the Economy Ministry spending an estimated total of \$500 million of the \$1 billion budgeted for buybacks. At the same time, local media focused on heated debates in congress over the GoA's proposed nationalization of flag carrier Aerolineas Argentinas and the potential drain this would cause on budget resources. (Aerolineas has historically been a poorly performing and heavily subsidized company, with debts estimated at US\$1 billion and operational losses at around US\$500 million per year.)

¶ 9. (SBU) Also during the week, persistent rumors of possible cabinet changes, including the replacement of Economy Minister Carlos Fernandez and the removal of Internal Commerce Secretary Guillermo Moreno from his (never formally acknowledged) oversight of INDEC generated column inches of media reports and, according to Embassy market contacts, significant trading volatility. On Thursday, August 14, credit rating agency Moody's changed the outlook on Argentina's B3 sovereign rating (six notches below investment grade) from "positive" to "stable", citing a more contentious and volatile political environment that raises concern the GoA may not be able to fully address economic policy challenges or adequately respond to potential economic or fiscal shocks. Nevertheless, at OOB Friday August 15, with the promise of continued GoA bond purchases, GoA bond prices had recovered almost fully from price declines suffered the prior week.

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Comment  
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¶ 10. (SBU) Despite mounting macro-economic stress, including real inflation estimated in the 25% range, Argentina's current economic performance remains relatively strong: 2008 GDP growth is projected in the still very respectable 6% range; the trend in the linked and closely watched debt/GDP ratio remains downward; the 2008 primary fiscal surplus, while under pressure, is projected to remain in the 2-3% of GDP range; and the current accounts trade surplus, while declining, remains fundamentally strong given still very favorable international commodity price terms of trade and a still undervalued nominal exchange rate. Markets have taken some comfort from recent fledgling steps by the Kirchner administration to address growing budget pressures that threatens the primary fiscal surplus. These include the recent decision to hike some electricity tariffs and to eliminate tax exemptions for fiduciary fund financial instruments.

¶ 11. (SBU) Despite these solid fundamentals, financial markets punished GoA debt on the week of August 4, with country-risk premiums topping 740 basis points, a level not seen since just prior to the 2001 default. And while the GoA's August 11-15 bond buyback program appears to have succeeded in restoring debt values and calming market jitters, our local market contacts characterize the government strategy as a reactive, ad hoc response to what they see as the GoA's continued inability to formulate coherent policy responses to growing macro-economic disequilibria. In particular, they cite the hermetic silence of Economy Minister Carlos Fernandez and his team over the past three months and speculate (hopefully, but without much justification as far as we can tell) that the Kirchner administration may soon call on either current central bank president Martin Redrado or former central bank president Mario Blejer to take over the portfolio in a way that more substantively addresses market concerns about the GoA's ability to cover debt maturity peaks in 2009 and 2010.

¶12. (SBU) Near-term steps that market players and local economists advocate include further hikes in utility and transport rates to reduce burgeoning subsidy payments that are a drag on fiscal accounts, cuts in government infrastructure spending growth to bring such spending more in line with revenue projections, and concrete steps to address market concerns about the GoA's ability to fund concentrations of debt maturities in 2009/2010 via some combination of debt rollovers with local banks and pension funds, seeking additional MDB credits, and perhaps tapping central bank reserves. They are also look for (as are we) a rumored presentation of a formal debt restructuring proposal to the Paris Club.

¶13. (SBU) Despite recent rating agency downgrades and significant increases in Argentina's country risk premium, most Embassy contacts discount any medium-term default scenario and note that the GoA has the capacity to fund itself in local capital markets through 2009 absent any radical drops in global commodity prices. Near-term market sentiment will likely turn on steps the GoA takes - or fails to take - in the coming weeks to demonstrate its long-term economic vision and commitment to fiscal probity.

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